# 3.03 Credit Losses & Sales of AFS Debt Securities

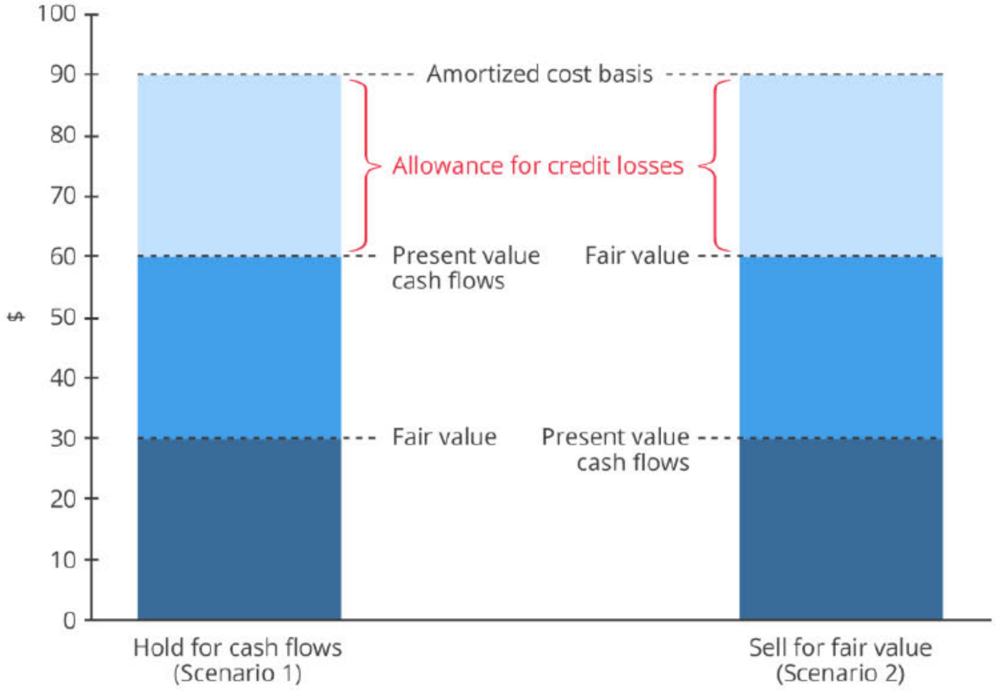
## Overview

As previously mentioned, ASC 326 specifies the reporting for declines in the value (ie, credit losses) of financial assets that result from the expected inability of the debtor to make all of the payments called for in the instrument. The two types of assets that are subject to the recognition of credit losses under ASC 326 include:

- Assets measured at amortized cost (previously discussed)
- Available-for-sale (AFS) debt securities (discussed here)

Remember, financial assets reported at fair value generally are not subject to the recognition of credit losses. This is because fair value is determined on the basis of market transactions, which assumes credit risk is considered when the the exchange price is determined.

While AFS debt securities are reported at fair value (ie, carrying value), if the fair value is lower than the present value of expected future cash flows, the instrument generally will be held and the cash flows will be realized (Scenario 1). If, however, the fair value is higher, it generally will be sold at its fair value rather than being held for the cash flows (Scenario 2). As a result, the allowance for credit losses would never be greater than the amount by which the amortized cost exceeds the fair value.



## Initial Measurement

Purchased financial securities are generally measured at the purchase price plus any costs incurred at acquisition that are appropriate for capitalization.

### Purchased Financial Asset with Credit Deterioration (PCD Assets)

Sometimes an AFS debt security is purchased with credit deterioration (PCD asset). This status is determined based on credit loss indicators and other criteria. When an AFS debt security is a PCD asset, the *initial allowance for credit losses is added to the purchase price* of the security (instead of being expensed) to get the *initial amortized cost basis*. Subsequent changes in the allowance will be recorded as credit loss expense.

### Credit Loss Indicators

Examples of credit loss indicators include:

- The difference between the security's amortized cost basis and its lower fair value
- Adverse conditions affecting the security, the industry of the issuer, or a relevant geographic area, which may result from:
  - Changes in technology
  - Discontinuation of a business segment that could adversely affect the issuer's future earnings or those of underlying loan obligors
  - Changes in credit quality
- The payment structure, along with the issuer's ability to make payments that increase in later periods
- Failure to make scheduled payments
- Changes in the issuer's security rating determined by a rating agency

## Impairments

Once the security has been recognized, an evaluation is to be performed each subsequent financial reporting date to determine if the AFS debt security has been impaired. If the fair value is lower than its amortized cost basis on the financial statement date, the asset is impaired. One must determine if the impairment is due to credit losses or other factors.

> Declines in the values of financial assets had previously all been recognized as impairment losses. Although they are not determined or measured in the same manner, credit losses are essentially the same as those impairment losses that result from the inability to pay, rather than those resulting from changes in market conditions.

### Determining Whether a Credit Loss Exists

When the present value of the cash flows expected to be received in settlement of the financial asset exceeds the amortized cost of the asset, there is no credit loss. If, however, the present value of future cash flows expected to be received is lower than the amortized cost basis of the

asset, a contra-asset (valuation) account, allowance for credit losses, and a credit loss expense is recognized. The allowance cannot reduce the carrying value of the asset below fair value though.

Credit losses are evaluated on investments individually or in groups, depending on how the entity aggregates them to recognize realized and unrealized gains/losses for financial reporting purposes. See the credit loss indicators above for considerations in determining whether a credit loss exists.

## Estimating Expected Credit Losses

All applicable available information should be used in making the determination of amounts and timing of cash flows expected to be collected. The information should include past and current events and conditions, and forecasts that are reasonable and supportable. Information considered should include:

- The remaining payment terms
- Prepayment speeds
- The issuer's financial condition
- Expected defaults
- The value of collateral, if any

Other sources of information that may relate to the evaluation include:

- Reports and forecasts of industry analysts
- Credit ratings
- Other relevant market data

## Changes in Credit Loss Allowance

It is possible for the timing of payments to be accelerated or delayed; the amount that is likely to be collected may increase/decrease; and a change in the market rate may cause the fair value of the instrument to increase/decrease. Depending on how these factors affect the fair value of the instrument, the valuation allowance may require an adjustment.

- Adjustments increasing the allowance create credit loss expenses in the period.
- Adjustments decreasing the allowance create a recovery of previously recognized credit losses, causing an increase in income.

## Decisions to Sell

In some cases, the entity may intend to sell the security, or it may be forced to do so due to working capital or other needs. Any allowance for credit losses associated with these securities is to be eliminated, and the security is to be written down to its fair value. The difference, an incremental impairment, is recognized in the period's earnings. If the entity does not intend to sell the security, it should still determine if it is more likely than not that it will be required to do so.

- After a security has been written down as a result of an intent to sell, the *difference between* the *new amortized cost basis* and *cash flows expected* to be collected is recognized as an *adjustment to interest income.*
- Subsequent increases in expected cash flows are recognized as prospective adjustments to the instrument's yield.

- Subsequent *increases in fair value* are recognized in *OCI*.

### Accrued Interest

If an entity reports accrued interest separately from the fair value and amortized cost basis of an AFS debt security, in the event that the cash flows are impaired, the entity may elect to write off the accrued interest receivables by reversing interest income or recognizing credit loss expense, or some combination of both.

## Financial Statement Presentation

An entity presents AFS debt securities on its balance sheet at its fair value, reporting the amortized cost basis and the allowance for credit losses parenthetically. Components of accumulated OCI related to AFS debt securities are reported separately in the balance sheet.

> No guidance is provided as to where credit losses are to be reported on the income statement. That may be determined on the basis of management's judgment, the component(s) of the entity the transaction was intended to benefit, or the component that generated the resources that were invested.

## Credit Loss Disclosures

Disclosures related to credit risk and the measurement of credit losses should provide information about:

- AFS debt securities with unrealized losses and no allowance for credit losses
- The allowance for credit losses
- Purchased financial assets with credit deterioration

The disclosures should enable financial statement users to understand:

- The credit risk that is inherent in AFS debt securities
- Management's estimate of credit losses
- Changes in estimated credit losses that occurred during the period

## Sales of AFS Debt Securities

When the investment in AFS is sold, the difference between the cost and the proceeds is treated as a realized gain/loss. Ignore the allowance account and adjust to the new target balance without the security that was just sold, unless it is the last investment, then the allowance and the unrealized gain/loss must both be eliminated.

## Reclassifications

Reclassifications may occur due to changes in management's intentions (ASC 320). Securities may be reclassified from one of the categories to another, and the accounting approaches vary depending on the old and new classifications. The approach is to treat the securities as if they are being sold from the portfolio they are leaving, then repurchased at the current market price into

the portfolio they are entering. In other words, current market price is used to determine the transfer.

| Type of transfer | Revalue at | Treatment of difference (ie, unrealized holding gains/losses) |
|---|---|---|
| **To trading*** | Fair value | Recognize in earnings (I/S) |
| **From trading** | | N/A (amounts already recognized in I/S are not reversed) |
| **From AFS to HTM** | | Amortize amounts in AOCI (B/S) over remaining life of security** |
| **From HTM to AFS** | | Recognize in OCI and transfer to AOCI (B/S) |

**Eliminate any related valuation allowance accounts.*

***Since AFS securities are carried at fair value, unrealized holding gains/losses should already be recognized in OCI and transferred to AOCI.*

Exam testing has historically focused more heavily on reclassifications between trading securities and AFS securities.